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# RETHINKING CORPORATE FIDUCIARY DUTIES: THE INEFFICIENCY OF THE SHAREHOLDER PRIMACY NORM

Gregory Scott Crespi\*

## I. INTRODUCTION

TO whom do corporate directors and officers owe their fiduciary duties of care and loyalty? The conventional understanding among modern courts and commentators is that such duties run exclusively to the corporation's common shareholders,<sup>1</sup> and that other financial claimants of the corporation, such as its bondholders and preferred shareholders, are generally entitled only to enforcement of their express contractual rights.<sup>2</sup> When corporate directors and officers ("corporate officials") make decisions within the remaining zone of discretion whose boundaries are defined by these contractual provisions, they are regarded as subject to a fiduciary duty to maximize shareholder wealth. Bondholders and preferred shareholders can therefore look only to the express terms of their contracts for protection of their interests since corporate officials are under a legal mandate to maximize shareholder wealth within those contractually-imposed limitations without regard for the impact of their actions upon those other financial claimants.

From this perspective, what role do fiduciary duties serve in the corporate context? They are best viewed as judicially-imposed "gap-fillers" that flesh out the details of the corporate officials' obligations created by the contracts between the various corporate financial claimants and the corporation.<sup>3</sup> These contracts are inevitably incomplete because of the high transaction costs of fully specifying state-contingent agreements that would cover all possible circumstances. Many situations arise where the

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1. Thomas A. Smith, *The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty*, 98 MICH. L. REV. 214, 214 n.3 (1999). But see Margaret Blair & Lynn Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 78 WASH. UNIV. L.Q. 403 (2001) (calling into question whether courts in fact generally accept the shareholder primacy norm).

2. "United States corporate law generally assigns control to equity; debt then bargains for specific contractual provisions to protect its interests. Similarly, under normal circumstances, managers owe duties to shareholders but not to bondholders." Frank Partnoy, *Corporate Finance: Adding Derivatives to the Corporate Law Mix*, 34 GA. L. REV. 599, 611 (2000).

3. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 90-93 (1991).

proper choices to be made by corporate officials are not completely determined by these contractual arrangements. There is an obvious need for courts to impose some principle of accountability to guide those officials in their exercise of the often substantial discretion left to them by their incomplete instructions, so to speak. The concept of an overriding fiduciary duty of loyalty owed to some entity or some single class of corporate claimants, such as common shareholders, provides a feasible standard for reviewing this exercise of discretion.

However, several different possible specifications of the locus of corporate officials' fiduciary duties may each be feasible in terms of the courts' ability to monitor and enforce such duties. As noted above, current judicial practice regards these fiduciary duties as running exclusively to the common shareholders, and not to the bondholders or preferred shareholders, or to the corporation as a whole.<sup>4</sup> Does this principle create the proper incentives for encouraging efficient resource allocation? Might it be that defining the corporation as a whole as the subject of these fiduciary duties would better promote economic efficiency? In this article, I will address this question.<sup>5</sup>

The framework of inquiry that I will utilize is a "hypothetical bargain" approach.<sup>6</sup> Which specification of the person(s) to whom the fiduciary duties of corporate officials run—the common shareholders or instead the corporation as a whole—more closely conforms to the hypothetical agreement that rational, wealth-maximizing bargainers in the positions of the various corporate financial claimants would have agreed to at the time the corporation was formed if the transaction costs of their negotiations were low enough to permit them to fully specify their contractual arrangements? Stated another way, which assignment of duties is more efficient—more closely replicates the jointly wealth-maximizing structure of rights and duties to which rational bargainers establishing a corporation would agree to in costless negotiations?

I will first conduct the hypothetical bargain inquiry under severely simplifying assumptions concerning the complexity of corporate capital structure and the degree of diversification of assets engaged in by the corporate shareholders and bondholders at the time that their contracts with the corporation are formed. I will then introduce more realistic assumptions in order to assess the significance of the breadth of the investment options currently available in capital markets, the growing complexity of corporate capital structures, and the insights of modern portfolio choice theory for the efficiency of fiduciary duty assignments.

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4. Smith, *supra* note 1, at 214 n.3.

5. This article will not address the issues presented by "constituency statutes" and the related commentary concerning the advisability of extending the fiduciary duties of corporate officials beyond financial claimants to other corporate stakeholder groups such as customers, suppliers, employees, etc. For an insightful discussion of these issues, and one that also addresses tangentially the concerns addressed in this article, see Blair & Stout, *supra* note 1.

6. Smith, *supra* note 1, at 216-17.

My initial analysis of the comparative efficiency properties of the two alternative fiduciary duty specifications, utilizing simplifying assumptions about corporate capital structures and investor diversification, leads to the conclusion that it would almost certainly be more efficient to regard those duties as running to the corporation rather than to the common shareholders. This result is even more strongly supported when one starts from more realistic corporate capital structure and investor diversification premises. My ultimate conclusion is that economic efficiency would be enhanced if the locus of corporate officials' fiduciary duties was redefined as running to the corporation, both for larger corporations with publicly-held securities and smaller corporations whose securities may be more closely held, and I recommend that courts and legislatures take this action.

My analysis builds directly upon a recent and important article by Thomas Smith.<sup>7</sup> The significance of this seminal article has not yet been fully recognized by courts and corporate law scholars.<sup>8</sup> My conclusions strongly affirm his insights concerning the implications of the broad investment choices offered by modern capital markets and of the conceptions of investor behavior utilized by modern financial theorists for the comparative efficiency of different fiduciary duty regimes.<sup>9</sup> In addition, I have attempted to extend his work in several ways.

First, I have tried to show that his arguments do not rest solely upon his strong assumptions as to the extent of investor diversification<sup>10</sup> or as to

7. Smith, *supra* note 1.

8. I am not aware of any court opinions citing to this article, though it has been cited with approval in the legal journal literature in at least a couple of instances. *See, e.g.,* Andrew D. Shaffer, *Corporate Fiduciary-Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 AM. BANKR. INST. L. REV. 479 (2000) (citing Smith with approval at several points in support of various propositions); Partnoy, *supra* note 2, at 616 (citing with approval Smith's point on the significance of the complexity of corporate capital structures for efficient fiduciary duty assignments); Blair & Stout, *supra* note 1, at 411 n.14 (citing Smith as an "outstanding work").

9. As Smith indicates:

The economic case for shareholder value maximization is, in fact, initially puzzling and ultimately unconvincing. If economic efficiency is the normative guidepost for substantive law, the principle norm of corporate law cannot be the maximization of shareholder value. . . . Rational corporate investors in a hypothetical bargain setting would not agree to shareholder value maximization as their gap-filling rule. . . .

They would agree to a norm that told managers to maximize the value of the diversified portfolios that CAPM says rational investors would hold. . . . A fiduciary duty running to the corporation itself would be most consistent with the gap-filling rule that emerges from hypothetical bargain analysis.

Smith, *supra* note 1, at 216-18.

10. Smith suggests that his call for redefinition of the fiduciary duties of corporate officials is limited to corporations with publicly traded securities for which the assumption of broad investor diversification seems most plausible:

For purposes of the neotraditional formulation of the corporate norm, however, corporations with publicly traded securities and closely held corporations should be clearly distinguished. This is because the logic of the neotraditional formulation is driven by the choices of rational investors in the capital markets . . . treating part owners of close corporations, who are more akin to partners in an enterprise, in the same way would not be justifica-

the scope of the "vicinity of insolvency" problem that I will later discuss in some detail. They are therefore even more compelling and of broader applicability than he claims. Second, I have attempted to shed some light upon the apparent reluctance of courts and scholars to embrace the position that both he and I advocate.

I have not addressed in this article any of the potentially important secondary issues that would be raised should the courts follow my recommendations and redefine the locus of the fiduciary duties of corporate officials as the corporation itself rather than its common shareholders.<sup>11</sup> I leave this analysis of transitional difficulties, implementation approaches, and the like to others more qualified to conduct it. I will, however, conclude this article by offering my speculations as to why the courts have thus far failed to redefine the locus of fiduciary duties in the manner I recommend, and these speculations do touch briefly upon matters of transition costs and implementation.

## II. THE SIMPLE CASE

For the sake of simplicity and clarity let me begin the analysis by considering a hypothetical negotiation among prospective corporate investors who wish to establish a corporation with a very simple capital structure: a single class of common stock equity, and simple non-convertible bond debt. Let me also assume that the prospective shareholders and bondholders of the firm are and intend to remain two entirely separate groups of investors, i.e., each intends to remain undiversified across equity and debt claims against this particular corporation.<sup>12</sup> Each group of prospective investors will therefore seek to have corporate officials act to maximize the value of their particular claims against the corporation, rather than the value of the combined claims of all classes of investors, i.e., the value of the corporation as a whole.

What framework of agreement would these persons reach regarding the duties of corporate officials if transaction costs were sufficiently low to allow negotiating a fully state-contingent set of contracts? Stated another way, what is the hypothetical wealth-maximizing bargain result that

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ble . . . . [Thus,] the conclusions that follow from the diversifications of rational CAPM investors do not apply directly to the close corporation context.

*Id.* at 257. I have attempted to demonstrate in this article, however, that the arguments for redefinition of fiduciary duties are even broader than Smith recognizes and do not require strong assumptions about the extent of investor diversification.

11. For example, a question would be presented concerning how non-shareholder claimants could enforce this duty. Would they be granted standing to bring derivative actions against the offending officials in the name of the corporation, as are common shareholders under current law?

12. The argument is not affected by whether these investors otherwise act as rational, risk-averse investors in accordance with modern financial theories of optimal portfolio choice, and thereby diversify their investment portfolios sufficiently in other ways so as to avoid the burden of unsystematic risk associated with their investment in the securities of the subject corporation.

the legal incentives and disincentives should be designed to facilitate in order to maximize efficiency?

First, it is clear that those persons would agree to restrict, in some fashion, the choice of firm investments to those that have a positive value for the investors viewed as a whole—investments whose combined effect on the market value of the firm's equity and debt would be positive. Investments with negative overall consequences for the investors would be prohibited; not only those investments that would hurt both classes of claimants, but also those investments that would increase the market value of the common shares but reduce the market value of the firm's debt by a greater amount, and those investments that would increase the value of the debt but reduce the value of the equity by a greater amount.

The reason for this result would not be the solicitude of either group for the interests of the other group. The reason instead would be that the parties would recognize that it maximizes their joint wealth. Because one group of investors would by definition lose more from those investments that do not increase overall corporate value than the other group would gain, in a rational bargaining context both groups would recognize that each would gain if at the outset the prospective losers from such investments agreed to make the side payments or other concessions necessary to fully compensate the prospective gainers, in exchange for those other persons agreeing to contractual provisions requiring corporate officials to forgo such investment opportunities.<sup>13</sup>

Under the assumption that transaction costs are low enough to permit the parties to fully specify their agreement, there would be no remaining zone of discretion left to corporate officials by the contractual arrangements that would require the imposition of any fiduciary duties for guidance. The result of this hypothetical bargain would be a complex and complete set of contractual restrictions and side payment arrangements which permitted corporate officials to select among only those investment opportunities that increased the combined wealth of the shareholders and bondholders and prohibited those officials from pursuing any other investment choices. Stated more simply, corporate officials would be directed to choose among only those opportunities that at a minimum increased the value of the corporation.

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13. Among the set of investment choices that have positive consequences for overall investor wealth, the shareholders would also seek to prohibit those investments within this set that reduced shareholder wealth, unless adequate compensatory side payment arrangements were agreed to *ex ante* by the benefiting bondholders, and the bondholders would similarly oppose those investment projects that increased overall investor worth but reduced bondholder wealth, absent sufficient shareholder *ex ante* side payments. Since by definition in this hypothetical situation the shareholders and bondholders are entirely distinct groups, and these would therefore be zero-sum disputes, all that we can be sure of in the abstract is that rational parties would agree to *ex ante* side payments at least sufficient to compensate the group of persons who would lose from a mutually wealth-enhancing investment option. Beyond this, the precise determination of the gain-sharing arrangements would depend on the relative bargaining power of the parties. The key point is that rational parties would reach contractual arrangements adequate to allow corporate officials to pursue those projects.

How closely does the current legal framework that requires corporate officials to regard common shareholders as the sole recipient of their fiduciary duties replicate such a hypothetical investor agreement reached under these simplifying assumptions? Not very well at all! For any investment possibilities falling within the zone of discretion left to particular corporate officials by the incompleteness of the applicable shareholder and bondholder contracts, the fiduciary duties currently imposed require those officials to pursue projects that increase shareholder wealth, even if they are not wealth-enhancing for the corporation as a whole, *i.e.*, will reduce bondholder wealth by more than they increase shareholder wealth.<sup>14</sup> Such investment projects do exist. For example, as Chancellor Allen of the Delaware Court of Chancery made clear in 1991 in his now-famous "vicinity of insolvency" footnote 55 in *Credit Lyonnais Bank v. MGM-Pathe Communications*,<sup>15</sup> risky investments made by a corporation that is in the "vicinity of insolvency" may well have adverse consequences for the wealth of the corporation, given the distribution and magnitude of the possible outcomes, but nevertheless may have positive consequences for the wealth of the common shareholders.<sup>16</sup> The shareholders will receive virtually all of the upside gains should such an investment prove successful,<sup>17</sup> yet because of their limited capital at risk when the firm is in the "vicinity of insolvency," the corporation's bondholders will bear much of the downside risk of unsuccessful results.<sup>18</sup> Moreover, given the availability in modern capital markets of opportunities for investors to take very large gambles on low-probability events, even large, well-capitalized firms are in the "vicinity of insolvency" with regard to at least some of their investment choices.<sup>19</sup>

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14. They also require those officials to forego opportunities that would increase the value of the corporation but reduce the value of the common shares.

15. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. CIV.A.12150, 1991 WL 277613, at \*1 (Del. Ch. Dec. 30, 1991). A number of courts in Delaware and elsewhere have cited this opinion for its vicinity of insolvency discussion. See, e.g., *Geyer v. Ingersoll Publ'ns. Co.*, 621 A.2d 784 (Del. Ch. 1992); *In re Buckhead Am. Corp.*, 178 B.R. 956 (D. Del. 1994); *Equity-Linked Investors v. Adams*, 705 A.2d 1040 (Del. Ch. 1997); *Odyssey Partners v. Fleming Cos.*, 735 A.2d 386 (Del. Ch. 1999); *Lasalle Nat'l Bank v. Perelman*, 82 F. Supp. 2d 279 (D. Del. 2000); *In re Mortgage & Realty Trust*, 195 B.R. 740 (Bankr. C.D. Cal. 1996); *In re Schulz*, 208 B.R. 723 (Bankr. M.D. Fla. 1997); *Ben Franklin Retail Stores, Inc. v. Kendig*, No. 97C7934, No. 976043, 2000 U.S. Dist. LEXIS 276, at \*1 (N.D. Ill. Jan. 11, 2000); *Management Techs., Inc. v. Morris*, 961 F. Supp. 2d 640 (S.D.N.Y. 1997); *Askanase v. Fatjo*, CIV.A. H-91-3140, 1993 U.S. Dist. LEXIS 7911, at \*1 (S.D. Tex. Apr. 22, 1993); *Weaver v. Kellogg*, 216 B.R. 563 (S.D. Tex. 1997).

16. *Credit Lyonnais*, 1991 WL 277613, at \*34 n.55.

17. There may also be some small benefits to the bondholders of a successful investment result because the resulting growth in the firm's equity cushion will reduce their insolvency risk with regard to future investments.

18. *Credit Lyonnais*, 1991 WL 277613 at \*34 n.55. See also Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1491 ("[I]f the management of a financially distressed company engages in extraordinarily risky activities, the upside gain accrues to shareholders while the creditors bear the downside risk.").

19. Smith, *supra* note 1, at 223-24.

In addition, a closely related point not explicitly recognized by Chancellor Allen in his *Credit Lyonnais* footnote is that even some investments *outside* of the “vicinity of insolvency”—investments that do not pose any insolvency risk even if the worst possible outcome results—can also result in expected shareholder wealth effects that diverge from expected corporation wealth effects. For example, an investment with widely diverging possible outcomes and no insolvency risk associated with any of the possible outcomes could potentially have positive consequences for shareholders if its expected returns are attractive, but the bondholders might value the possible diminution of the firm’s equity cushion against insolvency risk with regard to future operations of the corporation that would result from poor investment performance as more substantial and adverse than their benefit from the enhancement of the equity cushion that would be realized from successful investment performance.<sup>20</sup>

The current regime of fiduciary duties running exclusively to common shareholders now imposes upon bondholders the need to protect themselves with express contractual terms against the prospect of the corporation pursuing investments that would increase shareholder wealth but reduce bondholder wealth. The widespread use of such protective covenants should definitely *not* be regarded as *prima facie* evidence of their efficiency as a means of protecting bondholder interests. This is because under current law bondholders do not have the option of redefining contractually the locus of the fiduciary duty of corporate officials to themselves or to the corporation.<sup>21</sup> Their only remaining choice is to include protective covenants in their bond indenture designed to preclude shareholder-loyal officials from pursuing such investments, along with demanding a rate of return sufficient to compensate them for the residual risk that some investment options may later appear that are not precluded by the protective covenants. This practice therefore does not necessarily indicate that such provisions are less costly to negotiate than

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20. My point here is that there might well be a “diminishing marginal security from the equity cushion” effect at work for bondholders; an effect which is precisely analogous to the impact of the principle of the diminishing marginal utility of wealth which gives rise to the widespread phenomena of risk aversion with regard to fair or even slightly favorable gambles. Such “diminishing marginal security” could lead bondholders—for at least some investments that both promise expected gains to shareholders and are outside of the “vicinity of insolvency,” thus posing no insolvency risk—to value the possibilities of loss of some of their equity cushion against future insolvency risks that might result from an investment as more harmful than would be the offsetting benefit resulting from the possibilities of a gain in the size of that equity cushion.

21. Such a contractual provision would most likely be deemed unenforceable:

In practice, bondholders cannot contract into fiduciary or similar protection as a gap-filling rule that is superior to what shareholders get, whether or not they wanted to do so. . . . As interpreted by modern courts and academic commentators, such a provision would violate managers’ fiduciary duty to shareholders. . . . [A]s long as the governing rule is that shareholders benefit exclusively from a fiduciary duty and bondholders can get only express contractual protections, a contract term purporting to provide bondholders with something like gap-filling fiduciary protection would be unenforceable.

Smith, *supra* note 1, at 251.



would be a simple redefinition of the locus of residual fiduciary duties. To the contrary, these protective measures seem obviously inefficient compared to the more direct alternative of contractually imposing a fiduciary duty running to the corporation that would displace the judicially-imposed duty of shareholder loyalty. The latter approach would likely become the means of choice where such a contractual provision is to be regarded as creating an enforceable obligation.<sup>22</sup>

This legal framework should be contrasted with the framework that would likely develop if courts redefined the fiduciary duty of corporate officials as running to the corporation as a whole, rather than to the common shareholders. Such a duty would preclude corporate pursuit of "vicinity of insolvency" projects that would have positive impacts on shareholder wealth but negative impacts on overall corporate wealth, thereby obviating the need for bondholders to negotiate protective covenants to accomplish this same end.<sup>23</sup> Such a regime would markedly lessen the burden now imposed upon prospective investors to devise protective covenants precluding such investments under an incredibly broad range of circumstances difficult or impossible to anticipate in detail.

In brief summary, at least in theory the prospective investors could under either regime of fiduciary duty specification replicate the efficient hypothetical bargain outcome—restricting corporate officials to pursuing only those investments that increase the value of the corporation—by negotiating protective covenants that would effectively limit those officials in that manner. However, the transaction cost of doing so would likely be smaller under a legal regime that directly imposed upon corporate officials, as the default rule, the fiduciary duty to maximize the corporation's value than it would be under the current regime that imposes a different default rule—common shareholder wealth maximization—that must then be comprehensively countered by the bondholders with an elaborate structure of protective covenants.<sup>24</sup> In more general terms, the current legal regime requires the parties to the corporate nexus of contracts to contract around an inefficient default rule. It would be more efficient for the courts to promulgate a default rule that created the same incentives for corporate officials as would result from the hypothetical zero transaction cost bargain the parties would have reached. This would spare the parties the burdensome task of devising elaborate contractual restrictions

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22. *Id.*

23. It would also preclude pursuit of those projects discussed above in the text corresponding to note 20 that do not present insolvency risks but that have positive impacts on expected shareholder wealth and negative expected impacts on overall corporate wealth.

24. Laura Lin, in her 1993 article, favors as I do requiring corporate officials to maximize firm wealth, but takes a different position than I do on the relative efficiency of achieving this goal through imposing a fiduciary duty to that end versus requiring the bondholders to rein in the traditional shareholder wealth-maximization duty through protective covenants: "Directors should maximize the value of the firm regardless of its financial status, and the optimal means of reaching this goal is to require creditors to bargain for this duty [while retaining the shareholder wealth-maximization norm]." Lin, *supra* note 18, at 1510.

to rein in the inefficient incentive created by the fiduciary duty to maximize shareholder wealth.

I therefore conclude that at least under the very restrictive capital structure and investor diversification assumptions of this simple hypothetical, a plain vanilla common stock/bond capital structure and investors that are completely undiversified across the stocks and bonds of the corporation,<sup>25</sup> economic efficiency would be enhanced by shifting the locus of corporate officials' fiduciary duties from the common shareholders to the corporation as a whole.

### III. MORE REALISTIC ASSUMPTIONS

How robust is this conclusion with regard to more complex and realistic assumptions about corporate capital structures and the degree of investor diversification? If it is assumed that the subject corporation to be established through a hypothetical bargain is to have a more complicated capital structure that also involves one or more classes of preferred stock, and perhaps also different classes of common stock, and that its investors abide by the principles of modern portfolio theory and therefore hold fully diversified "market portfolios" of assets,<sup>26</sup> how do these changes in the underlying assumptions affect the conclusions reached above for the simple case as to the comparative efficiency of the two different fiduciary duty specifications being here considered? As will be shown below, introduction of those more realistic assumptions simply serves to further strengthen the conclusion that efficiency would be enhanced by redefining the locus of corporate officials' fiduciary duties to the corporation.

#### A. COMPLEX CORPORATE CAPITAL STRUCTURES

A more complex capital structure with different classes of preferred and common stock creates severe difficulties for corporate officials who seek to implement the current broad "maximize shareholder wealth" fiduciary duty directive. If there are several different classes of "shareholders," their interests may upon occasion be in conflict. Whose interests should take precedence in those situations?

I am not aware of any judicial opinions dealing directly with this interesting question. The resolution that would be most consistent with current law would be that corporate officials should regard their fiduciary duties as running to the firm's most residual claimants: those equity holders that are entitled to the remaining revenues once all the rights of higher-priority claimants have been met. This resolution would parallel the imposition of shareholder wealth maximization as the default fiduci-

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25. Although it is not necessary to assume that these investors are not otherwise fully diversified. See *supra* note 12 and accompanying text.

26. Such "market portfolios" are portfolios diversified across the different stock and bond securities of the subject corporation in proportion to their relative aggregate values, as well as similarly diversified between those securities and all other assets, and differ among investors only in their size and extent of leverage with borrowed funds.

ary duty for the simple stock/bond corporation—the common shareholders there being the firm's residual claimants—and the choice of any of the intermediate-priority stockholders or bond claimants rather than the residual claimants as the locus of corporate official fiduciary duties in a corporation with a complex capital structure would not be at all consistent with that basic principle.<sup>27</sup>

This particular resolution of the conflict of interest problem would lead, however, to other major problems that call into question the original premise. It is well understood that common shares in a corporation with bond debt are in an analogous position with regard to their incentives to engage in risky investments as are the holders of call options on an asset, with the amount of bond debt being the equivalent of the option exercise price.<sup>28</sup> This observation alludes back to the “vicinity of insolvency” problem noted by Chancellor Allen.<sup>29</sup> In a complex, multi-level equity capital structure, the most residual claims are equivalent to barely in-the-money call options (or even out-of-the-money call options if the total revenues that prior claimants are entitled to exceed the expected net revenues of the firm!). Imposing a fiduciary duty upon corporate officials to maximize the wealth of such thinly capitalized residual claimants presents the “vicinity of insolvency” problem in particularly stark fashion, as these claimants have little to lose and much to gain from highly risky investments, and would often favor even those investment options with negative overall expected values that could significantly reduce overall corporation value.

Recognition of the complexity of modern corporate capital structures therefore emphasizes the problem that the bondholders of such corporations, as well as the holders of all of the other classes of preferred stock and higher-priority “common” stock, are presented with by judicially-imposed fiduciary duties on behalf of the most residual claimants.<sup>30</sup> Complex capital structures magnify considerably the difficulties involved in negotiating the comprehensive contractual restrictions needed to ensure that only those investments that increase overall corporation value are undertaken. More different classes of parties with conflicting interests have to reach agreement, and the costs to those parties of leaving any gaps in the nexus of contracts are now larger because of the risk-loving nature of the residual claimants to whom the corporate officials' fiduciary duties run. As corporate capital structures become more complex, the increased comparative efficiency advantage of the “maximize corporation value” fiduciary duty principle becomes apparent when one considers both the enhanced necessity and the increased difficulty of achieving this

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27. Smith, *supra* note 1, at 261-63.

28. RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 234-35 (1993).

29. *Credit Lyonnais*, 1991 WL 277613, at \*34 n.55.

30. For an extended discussion of this problem, see Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEXAS L. REV. 1273 (1991). See also Partnoy, *supra* note 2.

result contractually by contracting around an economically perverse “maximize shareholder value” default rule.

### B. FULLY DIVERSIFIED INVESTORS

Let me now consider how the hypothetical corporation-forming negotiations among prospective investors seeking to establish a corporation with a complex capital structure will play out if all of those investors hold and intend to continue to hold fully diversified “market portfolios” in accordance with the recommendations of modern portfolio theory.<sup>31</sup> Such investors would each agree to purchase a diversified portfolio of all classes of debt and equity to be issued by the new corporation, blended in proportion to the relative aggregate values of those classes of securities. In other words, they would all elect to own the same fully diversified “vertical slice” of the different classes of the debt and equity claims against the corporation, and their overall positions would differ only in their size and extent to which they were leveraged with borrowed funds. These negotiations would obviously proceed rather smoothly since all parties would have essentially identical interests and concerns.

No party to the negotiations would argue for the imposition of fiduciary duties on corporate officials to maximize the value of the most residual class of securities—or, for that matter, of any single class of securities—rather than the corporation’s value as a whole, since the value of each investor’s portfolio of securities in the corporation will precisely track movements in overall firm value. Obviously no investor would favor the imposition of an economically perverse fiduciary duty that would then require all of them to comprehensively counter that duty through protective covenants. They would instead implement the principle of fiduciary obligations running to the corporation itself. Moreover, given the congruence of investor interests, this principle could be articulated simply and directly, rather than indirectly implemented as the resultant of a complex set of restrictions and side payment arrangements which would be necessary in the simple hypothetical negotiations discussed earlier where the interests of prospective shareholders and bondholders conflict in some significant regards.

How do the two alternative fiduciary specifications compare with respect to how closely they would replicate the terms of this hypothetical bargain? The answer is obvious: the difference in efficiency is dramatic and in favor of having the fiduciary duties run to the corporation. Having the locus of fiduciary duties run to the corporation itself precisely tracks the result of hypothetical negotiations among fully diversified investors, and would therefore spare such investors almost completely of the need to impose contractual limitations on management discretion. On the other hand, imposing a fiduciary duty on corporate officials to maximize the value of the firm’s most residual claims without regard to the impact

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31. See *supra* note 26.

on the value of the corporation as a whole goes against the interests of not just some but *all* of the firm's investors, requiring them to negotiate comprehensive contractual limitations to minimize the scope of discretion to which that economically perverse default duty would apply.

In summary, the introduction of more realistic assumptions as to the complexity of corporate capital structures and the diversification of investors highlights dramatically the economic inefficiency of the current fiduciary duty to maximize shareholder wealth and emphasizes the advantages of respecifying these fiduciary duties as running to the corporation as a whole.

#### IV. CONCLUSIONS

##### A. THE ARGUMENTS APPLY TO ALL CORPORATIONS

The arguments considered here are broad enough to justify redefining the locus of corporate officials' fiduciary duties for all types of corporations, be they large, publicly traded firms or instead small, closely-held companies. The case is most compelling for larger corporations with complex capital structures and whose investors are broadly diversified, but as I have demonstrated the argument also holds true for more simple corporations with investors who are completely undiversified across the firm's securities.<sup>32</sup>

Let me elaborate on these claims. As discussed above, for those corporations where the corporate investors are fully diversified across the corporation's different classes of securities, it is absolutely clear that maximization of the value of the corporation is more in accord with investor preferences than is maximization of the value of the most residual claims, and that there would be real transaction costs savings from the change that I recommend. Such broad investor diversification is likely to be the case, at least to a reasonable first approximation, for large corporations whose securities are publicly traded or privately placed with the larger institutional investors who serve as the diversification vehicles for their investor clients.

However, as previously discussed, the efficiency argument for redefining the locus of fiduciary duties of a corporation is bolstered by but does not require that its investors are diversified across the different classes of financial claims against the corporation. For small, closely-held corporations at the other end of the spectrum—where the shareholders and bondholders may be two entirely separate groups of investors—conflicts will still exist over the desirability of risky “vicinity of insolvency”-type investments. Under zero transaction cost circumstances, the anticipation of such conflicts would, as discussed above, lead to *ex ante* agreements among the investors to limit firm investments to those enhancing overall corporate value. Therefore, even under the circumstances of small,

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32. This conclusion is one area where I differ from the conclusions reached by Thomas Smith in his earlier work. See *supra* note 10.

closely-held companies with undiversified investors, a fiduciary duty to that effect would be more efficient than is the current fiduciary duty to maximize shareholder value, which requires elaborate protective covenants to circumvent.

The law should accordingly be changed across the board for all corporations. The sweeping nature of this recommendation yields an additional advantage. Its adoption will therefore not result in any difficult definitional line-drawing problems for corporate officials and courts comparable to those that were identified by the commentators assessing the merits of the *Credit Lyonnais* "vicinity of insolvency" exception.<sup>33</sup>

## B. IMPEDIMENTS TO THE CHANGE

Given the rather straightforward and compelling economic efficiency arguments for respecifying the fiduciary duties of corporate officials to run to the corporation as a whole rather than to its shareholders, one wonders why this change in the law has not yet occurred. What is the impediment here that has prevented courts (and legislatures) from taking decisive action? One can only speculate on the reasons for inaction, but I have a few preliminary thoughts on this question.

A review of the judicial and scholarly reaction to the *Credit Lyonnais* "vicinity of insolvency" footnote suggests one explanation. The discussion by Chancellor Allen, as previously noted, suggested that when a firm is in the "vicinity of insolvency" the locus of corporate officials' fiduciary obligations should be broadened to include bondholders as well as shareholders, and perhaps even the corporation as a whole.<sup>34</sup> The response by the scholarly commentators to his initiative has been lukewarm at best,

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33. See, e.g., Lin, *supra* note 18, at 1512 (describing the vicinity of insolvency exception as "ill-defined."); C. Robert Morris, *Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 IOWA J. CORP. L. 61, 67-68 (1993) (Under the vicinity of insolvency exception "it is difficult to find a principled stopping place . . . [and] to impose just solutions to this problem."); Rima Fawal Hartman, *Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?*, 50 WASH. & LEE L. REV. 1761, 1766 (1993) (the *Credit Lyonnais* vicinity of insolvency exception is of uncertain scope); Stephen R. McDonnell, *Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors' Burden From Shareholders to Creditors*, 19 DEL. J. CORP. L. 177, 178 (1994) (describing the vicinity of insolvency exception as ambiguous as to timing and standard of review); Brent Nicholson, *Recent Delaware Case Law Regarding Director's Duties to Bondholders*, 19 DEL. J. CORP. L. 573, 575 (1994) (criticizing the vicinity of insolvency exception as "regrettably ambiguous in its timing and scope."); Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 672 (1996) (noting the valuation difficulties, the cost of implementation, and the sensitivity to the assumptions made of the vicinity of insolvency exception); Ramesh K.S. Rao et al., *Fiduciary Duty à la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 IOWA J. CORP. L. 53, 62-64 (1996) (criticizing the vicinity of insolvency exception as overly broad and ambiguous); Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 72 (1998) (criticizing the vicinity of insolvency exception as ambiguous); Christopher L. Barnett, *Healthco and the "Insolvency Exception": An Unnecessary Expansion of the Doctrine?*, 16 BANKR. DEV. J. 441, 465 (2000) (describing the vicinity of insolvency exception as a "fuzzy concept."); Shaffer, *supra* note 8, at 512-20 (noting the complexities of defining corporate insolvency).

34. *Credit Lyonnais*, 1991 WL 277613, at \*34 n.55.

with much of the criticism focusing on the difficulties corporate officials would have in defining "insolvency" and in then determining when the corporation was in the "vicinity" of such a condition.<sup>35</sup> The judicial response has also been mixed. Some courts have endorsed the *Credit Lyonnais* "vicinity of insolvency" exception, although none have extended its application beyond near-insolvency circumstances.<sup>36</sup> Other courts have been less enthusiastic. The subsequent Delaware case of *Geyer v. Ingersoll Publications, Co.*<sup>37</sup> arguably limited the *Credit Lyonnais* exception to situations where the corporation was actually insolvent rather than merely in the "vicinity of insolvency,"<sup>38</sup> and a number of courts have followed this restrictive interpretation of the *Geyer* ruling.<sup>39</sup>

The muted character of the response to Chancellor Allen's proposal highlights the inherent conservatism and incrementalism of the legal system, which often, but not always, serves us well. He articulated the new "vicinity of insolvency" concept in traditional fashion as an exception of limited scope to the enduring principle of a fiduciary duty of shareholder wealth-maximization, rather than as I have done here as one of several concerns together supporting a wholesale repudiation of that principle. In the same gradualist spirit as shown by the Chancellor, the courts and commentators have concerned themselves with the narrower problems of defining the scope of and implementing such an exception and have, for good reasons, found them to be daunting.<sup>40</sup> While I am convinced that imposing fiduciary duties in favor of shareholders is less efficient than imposing them in favor of the corporation as a whole, I concede that it

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35. See, e.g., Norwood P. Beveridge, Jr., *Does a Corporation's Board of Directors Owe a Fiduciary Duty to Its Creditors?*, 25 ST. MARY'S L.J. 589 (1994) (arguing there is no case law support for the vicinity of insolvency exception). See also the writers cited *supra* note 33, who each express concerns about the feasibility of imposing workable limits on this exception.

36. See, e.g., *In re Buckhead*, 178 B.R. at 968; *Equity-Linked Investors*, 705 A.2d at 1042 n.2; *In re Schultz*, 208 B.R. at 729; *Ben Franklin Retail Stores*, 2000 U.S. Dist. LEXIS at \*11-13; *Management Technologies*, 961 F. Supp. 2d at 645; *Askanase*, 1993 U.S. Dist. LEXIS at \*12-14; *Weaver*, 216 B.R. at 582-84.

37. 621 A.2d 784 (Del. Ch. 1992).

38. The *Geyer* opinion specifically held that the *Credit Lyonnais* vicinity of insolvency exception can "arise at the moment of insolvency in fact rather than waiting for the institution of statutory [insolvency] proceedings." *Id.* at 789. The difficult question is whether this ruling should be regarded as limiting the scope of that exception to instances of insolvency in fact, rather than applying also to near-insolvency situations, or as merely declaring that the exception does not require the commencement of statutory insolvency proceedings. As noted *infra* note 39, a number of courts have read *Geyer* as limiting the scope of the exception. For an opinion arguing strongly to the contrary, see *Weaver*, 216 B.R. at 583 n.30:

[The *Geyer*] court made this statement in the context of its decision that in order for a plaintiff to invoke the insolvency exception, it is not necessary for the corporation to have actually declared bankruptcy. In this statement, the court was merely rejecting one narrow interpretation of insolvency; it was not limiting its earlier description [in *Credit Lyonnais*] . . . of the circumstances in which directors owe fiduciary duties to creditors.

39. See, e.g., *Odyssey Partners*, 735 A.2d at 417; *Lasalle Nat'l Bank*, 82 F. Supp. 2d at 290; *In re Mortgage & Realty Trust*, 195 B.R. at 750-51; *In re Healthco*, 208 B.R. at 300-01; *In re Zale*, 196 B.R. at 354-55.

40. See *supra* note 33.

may well be that attempting to fine tune the current fiduciary duty regime with an inherently imprecise insolvency-based exception is unworkable. In more general systems theory terms, it may be that the current fiduciary duty regime is a local but not a global optimum that is more efficient than the closely neighboring possibilities, even if it is, as I claim, far inferior to a more radical alternative. A legal system limited to making only incremental improvements may well remain indefinitely at a local optimum that is globally suboptimal.

A second possible reason for judicial reluctance to make the change that I recommend could be the perception that even if the new regime would have on balance significant efficiency advantages, the transition costs of such a major change—which would include among other elements the efforts required by numerous corporate officials to understand and implement their new duties, and the need for courts and legislatures to develop procedural mechanisms, such as expanded derivative suit filing rights, etc., whereby bondholders, preferred shareholders, and other non-residual equity claimants could effectively enforce the new fiduciary duty scheme—might outweigh those benefits. As noted earlier, the evaluation of such transition cost or procedurally-based objections would require a separate and extensive analysis.

One final impediment may be that some judges who are only slightly familiar with this controversy might misunderstand the motivations of the persons calling for change. It was really not until well into the 20th century that lawyers and judges began to accept that the fiduciary duties of corporate officials ran to the common shareholders rather than to the corporation itself.<sup>41</sup> Before that time, most persons saw the fiduciary duties as running to the corporation. However, they did not have modern capital markets or modern financial theory in mind, but were instead operating with a conception of the essential nature of corporate personhood which would strike most modern observers as an excessive and quaint “reification” of a mere legal fiction.<sup>42</sup>

Some judges today may therefore regard the calls to redirect corporate officials’ fiduciary duties to the corporation as a whole as merely the lingering echoes of these early 20th-century views. I trust that the reader of this article recognizes that the arguments I am offering do not merely reflect a nostalgic yearning for the resurrection of discarded conceptions of the nature of corporate personhood, but are based upon a rational choice theory assessment of the consequences of the current availability of large and highly risky investment options through capital markets, the complexity of modern corporate capital structures, and the implications

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41. Smith, *supra* note 1, at 243. See also Shaffer, *supra* note 8, at 492 (“Until the 1930’s it was generally thought that the exclusive beneficiary of the fiduciary relationship was the corporation alone.”).

42. The Oxford English Dictionary defines reification as “[t]he mental conversion of a person or abstract concept into a thing.” 13 THE OXFORD ENGLISH DICTIONARY 532 (2d ed. 1989). For discussion of early 20th century concepts of corporate personhood, see Smith, *supra* note 1, at 244-45 nn.72, 73.



of modern financial theories of optimal portfolio choice. I hope that the courts and legislatures will eventually come to the same realization and act accordingly.